

Internal Revenue Service

memorandum

TL-N-1539-88

CC:TL:TS/TSANDERSON

date: **01 MAR 1988**

to: District Counsel; San Jose W: SJ
Attn: Steve Sibley

from: Director, Tax Litigation Division CC: TL: TS

subject: [REDACTED]

This memorandum responds to your request for technical advice of December 2, 1987.

Issue

What is the primary method for determining the fair market value of the [REDACTED] wind turbine generators for depreciation and credit purposes under the theory that the basis of property for such purposes should be limited to its fair market value when the transaction is based upon "peculiar circumstances" which influence the purchaser to agree to a price in excess of the property's fair market value, such as the "turnkey" or "package" nature of these investments.

Conclusion

In absence of comparable sales, the most reliable guide to an asset's value is, in most cases, its earning power. The discounted cash flow method, as used here, is an appropriate method of valuing an asset based on its earning power. However, in valuing the wind turbine generators, this present value analysis should never be used alone. Furthermore, in the statutory notice of deficiency, the fair market value determined under the reproduction cost method should be asserted in the alternative.

Facts

The petitioners above invested in a wind energy shelter through [REDACTED], in [REDACTED]. On [REDACTED], the Service issued a statutory notice disallowing the investment tax

008439

credit, business energy credit, depreciation and operating expenses with respect to the investment in the wind energy shelter.

The primary grounds for disallowing the credits were that the petitioners had not established: the amount, if any, of the qualified investment, that the property qualifies for an investment tax credit or business energy credit, and that the property was placed in service. The primary grounds for disallowing the depreciation and operating expenses were that the petitioners had not established that the expenses claimed were incurred in a trade or business, for the production of income, or in an activity engaged in for profit. 1/

The petitioners based their credits and depreciation on the entire purchase price, \$[REDACTED], representing that it was paid entirely for the purchase of a wind turbine generator (WTG). In fact, this investment, like other similar wind energy shelters, was a "turnkey" arrangement wherein the investor was provided a WTG plus the services and rights associated with the establishment and operation of a wind park. A review of the various offering documents discloses that in fact the investment was in a "package" of assets. The package included the tangible WTG and various intangible assets, which may or may not be subject to amortization.

Discussion

An alternative theory that should be advanced in these cases is that the basis for determining the allowable amounts of depreciation and credits should be limited to the fair market value of the WTGs at the time of purchase.

The amounts of depreciation and credits depends on the basis of the property. As a general rule, the basis of property for these purposes will be its cost, and cost usually equals the price paid for the property. However, this rule does not apply "where a transaction is not conducted at arm's-length by two self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981). "In such cases, the basis of property for tax purposes may be limited to its fair market value." Id. See also Waddell v. Commissioner, 86 T.C. 848, 912 (1986).

In Lemmen, which involved a cattle-breeding venture, the Court said:

1/ We note the absence of the placed in service ground for disallowing the depreciation.

Clearly, however, in purchasing a "package" comprising cattle and a maintenance contract, petitioner had an obvious incentive to agree to an inflated purchase price for the cattle (at the expense of what might otherwise be treated as prepaid maintenance) so as to increase the investment credit and deduction for accelerated depreciation to which he would be entitled. At the same time, CCR in offering "managed breeding herds" had an incentive to include disguised future maintenance fees in the sales price of the cattle. By so doing, CCR could confer the above tax benefits on its investors at little or no cost to itself, thus sweetening the investment for the high-bracket taxpayers for whom the breeding program was designed. In these "peculiar circumstances" (Bixby v. Commissioner, supra), we find that petitioner's cost basis in his cattle must be limited to their fair market value, i.e., \$7,000 per herd. Compare Bernuth v. Commissioner, supra.

Lemmen, supra at 1349.

As discussed above, the [REDACTED] investors were similarly purchasing packages which included the WTGs and intangibles, which are not subject to depreciation or credits. Under these "peculiar circumstances," the basis for determining the allowable amounts of depreciation and credits should be limited to the fair market value of the WTGs at the time of purchase.

This alternative theory should be asserted in all statutory notices. For similarly situated investors to whom statutory notices have already been issued that did not include this alternative theory, the investor should be apprised that the Service is asserting this theory. In such event, the claim should be raised before the Tax Court, if necessary, in the appropriate manner.

Fair market value is generally defined for tax purposes as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." See, e.g., Treas. Reg. § 20.2031-1(b). Of course determining fair market value is not an exact science and is largely a question of fact. In making this determination, the Service, as well as the courts, will usually rely on expert opinions.

There are three general methods for valuing assets: the market, cost, and income stream or discounted cash flow methods. The market approach, it is universally agreed, is inappropriate in these cases because of the present lack of identified comparable sales outside of turnkey arrangements.

In the absence of comparable sales, one view is that the most reliable guide to an asset's value is its earning power, as opposed to the cost to reproduce the asset. Chicago Railway Equipment Co. v. Commissioner, 13 B.T.A. 471 (1928); Jarecki Manufacturing Co. v. Commissioner, 12 B.T.A. 1165 (1928); Hudson River Woolen Mills v. Commissioner, 9 B.T.A. 862 (1927); 14 Mertens, The Law of Federal Income Taxation § 59.11 (1984).

In any event, a present value analysis of the earning potential of the asset is certainly a legitimate method of determining the asset's fair market value. The Tax Court has become more and more receptive to the present value analysis. See Soriano v. Commissioner, 90 T.C. No. 4 (January 11, 1988); Rose v. Commissioner, 88 T.C. 386, 418 (1987) (present value approach was utilized in arriving at a ceiling fair market value of the subject property); Waddell, supra; Pritchett v. Commissioner, 85 T.C. 580, 591 (Simpson J., concurring) and 598 (Hamblen, J. dissenting); Hilton v. Commissioner, 74 T.C. 305, 353 n. 23 (1980). But see Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n. 52 (1985) (declined to use a present value analysis in determining the economic viability of the transactions).

Therefore, the use of the discounted cash flow method, a form of present value analysis used by your engineer, in these cases is appropriate. Furthermore, since it results in the lowest fair market value, the fair market value determined under the method should be the primary value asserted under the basis-limitation theory above.

However, the use of this present value method is problematic. The main problems involve choosing a discount rate and determining the income or cash flow to be discounted. Additionally, the fair market value determined under the present value method could be viewed as representing the value of the entire investment, as opposed to just the value of the tangible asset. As discussed above, the investment was in a package which consisted of the tangible WTG and intangibles. Therefore, the fair market value of the entire investment, as determined under

the present value analysis, could be greater than that of the fair market value of just the tangible asset, determined independently under the same method. 2/

The presence of these problems does not mean that the present value method should not be used. 3/ In light of these problems, however, we have required technical advice in order to use this type of method. We will no longer, however, require technical advice as long as the present value method is used in the alternative with the reproduction cost method. This is because the reproduction cost method is also a legitimate valuation method in these cases and could serve as a backup position if needed in settlement negotiations or litigation. 4/

Therefore, for statutory notices issued asserting the alternative theory discussed above, assuming there is sufficient time, a definite fair market value should be determined under each of the two methods. The notice should state the fair market value determined under the present value method as the primary fair market value. The notice should also state the fair market value determined under the reproduction cost method, in the alternative. For all other cases, the alternative fair market values should be determined, the investors should be apprised of the alternative values consistent with the above, and the

2/ An analysis of what income is attributable solely to the tangible asset would have to be made in order to assert any lower fair market value for the WTG. There is probably not enough time to make such an analysis prior to issuing the remaining statutory notices. We suggest, however, that an analysis should be conducted in this regard to determine the fair market value of the tangible and intangible assets. Additionally, all other appropriate methods should be used to value the intangible assets. From this, it can be determined whether it is justifiable to assert any resulting lower fair market value for the WTG. The analysis of the fair market value of the intangible assets would also be helpful in determining the appropriate amount of amortization, if any.

3/ In fact, the latter problem may present another reason to use the method since an argument could be made that the fair market value of the tangible asset certainly should not exceed the fair market value of the entire investment. See Rose, supra. at 418. In light of this problem, however, it may be more appropriate to state, when asserting that the basis should not exceed the fair market value of the WTG, that the fair market value of the tangible asset should not exceed the fair market value of the entire investment. Then the primary fair market value used would be the fair market value of the investment as determined under the present value analysis.

4/ We note that some view the use of the reproduction cost method as being more appropriate in these cases.

alternative values should be brought to the attention of the Tax Court if the alternative theory is raised for the first time in the answer or amended answer.

If you need any further assistance with this matter, please do not hesitate to contact Ted Sanderson on (FTS) 566-3233.

MARLENE GROSS

By: Kathleen E. Whatley
KATHLEEN E. WHATLEY
Chief, Tax Shelter Branch